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⁴⁸ Deven Sharma, *Why Rating Requirements Don't Make Sense*, THE WALL ST. J., Jan. 19, 2010, at A-23.

⁴⁹ Serena Ng, *Ex-Moody's Analyst to Testify on Industry's Conflicts of Interest*, THE WALL ST. J., Sept. 24, 2009, at C-3.

⁵⁰ Scannell and Lucchetti, *supra* note 1.

⁵¹ Aaron Lucchetti, *Big Credit Rating Firms Agree to Reforms*, THE WALL ST. J., June 6, 2008, at C-3.

IRS PRESSES FOR TRANSPARENCY ON TAX ACCRUALS

By

Martin H. Zern *

The art of taxation consists in so plucking the goose as to procure the greatest quantity of feathers with the least possible amount of hissing.

—JEAN-BAPTISTE COLBERT

I. INTRODUCTION

Recently, the Internal Revenue Service (IRS) announced that corporations and businesses generally will be required to reflect on their tax returns any tax position that is considered inconsistent with Financial Accounting Standard Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes, or similar financial reporting standards.¹ To this end, the IRS has developed a new form (Form 1120 Schedule UTP) that will have to be filed annually by some corporations.²

Clearly, the IRS is seeking more transparency from corporations and businesses in general regarding their tax planning ventures, which some may categorize as tax evasion schemes or even scams. No doubt the government's stance is attributable to its need for more revenue and the overall tone of hostility by much of the general public to large corporations in light of the recent – and perhaps continuing – financial crisis. Many believe that corporations are unfairly reducing their tax liability by utilization of aggressive corporate tax shelters that often have no purpose other than tax reduction.

The posture of the IRS in pressing corporations for more transparency seems partly attributable to a recent favorable court decision involving *Textron Inc.* that considered whether

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the IRS is entitled to review corporate tax accrual work papers. This article will analyze this decision by the First Circuit Court of Appeals. Despite an important IRS victory in this case, IRS Commissioner Shulman noted the IRS will continue to exercise "restraint" in seeking tax accrual work papers, which often include the corporation's tax reserve amount and assessment of risk on owing more taxes relative to certain transactions. Not so moderate, will be a requirement that taxpayers disclose "uncertain tax positions" with their tax return. All the details are yet to be promulgated by the IRS regarding the factors that tax advisors will have to consider in making a determination as to whether a tax position is uncertain. Of course, there are different degrees of uncertainty. The disclosure of uncertain tax positions would have to be made at the "time of filing" using Schedule UTP.

Commissioner Shulman observed that "[t]oday, we spend up to 25% of our time during large corporate audits searching for issues rather than having a straightforward discussion with the taxpayer about the issues." According to the Commissioner, the IRS goal is to complete an audit while reducing the time looking for information. Initially, business taxpayers with assets over \$100 million that have financial statements prepared under FASB Interpretation No. 48 or similar accounting standards, and which reflect uncertain tax positions, will have to disclose such information when their tax returns are filed. This will extend to taxpayers with assets over \$10 million under a 5-year phase in.³ The Commissioner noted that a "concise" statement of the tax position will suffice.

The Commissioner stated that business taxpayers will not be required to disclose their risk assessment -- that is, how strong or weak they regard a tax position -- or how much they reserved on their books. The IRS is taking a "reasonable approach" and that "[w]e could have asked for more -- a lot more -- but chose not to." By so stating, it appears that the IRS is making a veiled threat to business taxpayers that are not more forthcoming in disclosing potentially uncertain tax positions. Another major reason for seeking more transparency is the IRS goal of becoming more efficient. Obviously, the IRS does not want its auditors spending numerous man-hours hunting for issues that might result in a tax assessment with the time and effort expended to no avail.

II. TEXTRON

On August 13, 2009, the First Circuit Court of Appeals decided *United States of America v. Textron Inc. and Subsidiaries*.⁴ The case was appealed from the United States District Court for the District of Rhode Island, which had rendered a decision in favor of *Textron*, holding that the IRS was not entitled to *Textron's* tax accrual work papers. The case was appealed to the First Circuit Court of Appeals and initially heard by a three judge panel, which affirmed the District Court 2 to 1. While this would have normally been the end of the case, the government requested a further hearing, *en banc*, which was granted. In a 3 to 2 decision, the First Circuit reversed itself, holding that the IRS was entitled to access to *Textron's* tax accrual work papers.

The government's persistence in *Textron* is consistent with its efforts in recent years to attack the use by corporations of aggressive, and possibly illegal, tax shelters. The importance of this case to both the IRS and taxpayers can be gleaned from

the effort put in by the government in pursuing an ongoing controversy regarding disclosure of tax accrual work papers. Six high-level Government lawyers were involved in the case while Textron was represented by two major law firms. Corporate concern about the case is evidenced by the fact that a law professor, the National Chamber of Commerce Litigation Center, Inc. and the Association of Corporate Council submitted *amicus curiae* briefs on behalf of Textron.⁵

Textron, Inc. is a publicly traded major aerospace and defense conglomerate with well over 100 subsidiaries. It files a consolidated income tax return and is audited regularly by the IRS. As a publicly trade company, its financial statements must be certified by an independent auditor.⁶ The financial statements must show reserves to account for contingent tax liabilities and must reflect an estimate of potential tax liability in the event of an IRS audit. The reserves are supported by work papers upon which the independent auditor relies in order to certify that the financial statements are correct.

Textron's tax department lists items in its tax return that if identified and challenged by the IRS could result in an additional tax assessment. Spreadsheets list each debatable item with the dollar amount subject to challenge along with a percentage estimate of the IRS's chances of success. The book reserve is calculated by multiplying the percentage times the questionable item stated in dollars. Work papers, backed up by emails and other notes, support the calculations. The Supreme Court has noted that access to tax accrual work papers would give the IRS the ability to "pinpoint the soft spots" on a company's tax return to support additional tax liability.⁷

The IRS has not automatically requested tax accrual work papers. But as a result of corporate scandals like Enron, it began seeking work papers where it believed that the taxpayer

had engaged in certain "listed transactions" the IRS has concluded might manifest tax evasion.⁸

The Textron case evolved from a 2003 audit of its tax returns for 1998-2001, which revealed that in 2001 Textron had engaged in nine listed transactions through one of its subsidiaries involving equipment purchases from a foreign entity with a lease back, on the same day, to the seller. These deals are known as sale-in, lease-out (SILO), transactions, which are listed by the IRS as possibly abusive tax shelters.⁹

Textron had shown its work papers to its outside auditor, Ernst & Young, but refused to show them to the IRS auditors. In response, the IRS issued an administrative summons seeking relevant documents.¹⁰ If only one transaction is questionable, IRS policy is to seek work papers for that transaction. However, where more than one transaction is involved, the IRS policy is to request all the work papers for the tax year.¹¹ When Textron refused to abide by the summons, the IRS initiated an enforcement action in District Court in Rhode Island.¹² As a defense, Textron asserted attorney-client and tax practitioner privileges, and the qualified privilege for litigation materials under the work product doctrine. The IRS challenged the privilege claims.

At trial, evidence revealed that Textron's work papers were prepared by its in-house tax lawyers and that outside counsel had been retained to advise Textron on its tax reserve requirements. Textron admitted that in some instances its spreadsheets estimated the probability of IRS success on a challenge to the transaction at 100%. Textron also noted that although its spreadsheets had been shown to and discussed with its outside auditor Textron retained them. Testimony on behalf of Textron asserted that litigation over specific items on

its spreadsheets was always a possibility. The IRS agreed but claimed this was unlikely.

The trial court denied the IRS petition for enforcement.¹³ It agreed that the IRS had a legitimate reason for seeking the work papers and that Textron waived the attorney-client privilege and the tax practitioner privilege for non-lawyers by showing the work papers to Ernst & Young. Nevertheless, it concluded that the work papers were protected by the work product privilege derived from the Supreme Court decision in *Hickman v. Taylor*¹⁴ and since codified in Rule 26 (b)(3) of the Federal Rules of Civil Procedure. The court concluded that the work papers served to satisfy Textron's outside auditors that its tax reserve was satisfactory so that it could get a "clean" opinion. However, the work papers, which showed estimated hazards of litigation percentages, would not have been prepared "but for" the fact that Textron anticipated litigation with the IRS.

Although it had initially affirmed the District Court decision, after the *en banc* rehearing, the First Circuit reversed holding that the work product privilege did not apply. The court claimed that in so holding it was reaffirming its prior decision in *Maine v. United States Dep't of Interior*.¹⁵

The court observed that the work product privilege derived from the Supreme Court's decision in *Hickman*, where there was ongoing litigation, and where the focus was on typical papers lawyers prepare for litigation. Often, such material and other items that are planned for use at trial are not obtained from or shared with clients and therefore are unprotected by the attorney-client privilege. *Hickman* dealt with whether an adverse party could inquire into oral or written statements secured by opposing counsel in preparation for litigation that had already commenced. *Hickman* cited a privilege in English

courts protecting documents prepared for, but not necessarily only for, assisting advisors in actual or anticipated litigation. Such documents (which might be interviews, memoranda, correspondence briefs, mental impressions, personal beliefs, outlines for cross examination and countless other items) are termed the work product of the lawyer. *Hickman* concluded that the witness interviews were protected by the work product privilege.

The court stated that the IRS was correct in asserting that the immediate motivation for Textron to prepare tax accrual work papers was to establish the tax reserve on its books and get a clean opinion. Further, that no reserve would have been necessary unless there was the possibility of the IRS disputing a transaction. The court observed, however, that the district court did not say the work papers were prepared "for use" in litigation, but only that they would cover liabilities that might be determined in litigation. The court concluded that the failure to make a "for use" finding was clearly erroneous.

The court noted that an IRS expert testified that even if litigation were remote, the work papers would still have to be prepared to support Textron's judgment on the reserves. Furthermore, based on Textron's own experience, it was clear that those issues noted with a high percentage of IRS success would never be litigated. Even an academic supporter of Textron concluded that "it is doubtful that tax accrual work papers, which typically just identify and quantify vulnerable return positions, would be useful in the litigation anticipated with respect to those positions."¹⁶

The court observed that an experienced litigator would not consider tax accrual work papers as litigation materials. The work product privilege has always been on litigation. The privilege will not be triggered by an assertion that the

documents in question could relate to a matter that “might conceivably be litigated.” As the Supreme Court stated in *Federal Trade Commission v. Grolier, Inc.*, “the literal language of Rule 26(b)(3) protects materials prepared for any litigation or trial as long as they were prepared by or for a party to the subsequent litigation.”¹⁷ In considering whether the work product privilege is applicable, the key inquiry is the function the document serves.¹⁸ The court pointed out that the privilege does not attach simply because the work papers were “prepared by lawyers or represent legal thinking.” Only if they are used in or in anticipation of trial are they protected. The court mentioned that lawyers who try cases know the “touch and feel” of work product papers.

Citing its *Maine* decision, the court stated that the privilege does not extend to “documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation.” The court concluded that *Maine* supported its decision in the present case. Also, the court referred to the only other circuit court case that it believed addressed the issue of privilege for tax accrual work papers. This was the decision of the Fifth Circuit in *United States v. El Paso Co.*¹⁹ This case also denied work product protection employing a “primary purpose” test. The Fifth Circuit found that the “sole function” of the work papers was to support financial statements.

The First Circuit concluded that there was no evidence that Textron’s work papers were prepared for use in litigation or that they would serve any useful purpose in conducting litigation. The work papers were prepared because Textron has a legal obligation as an exchange-listed company to comply with the securities laws and generally accepted accounting principles for its certified financial statements.

The court then addressed Textron’s argument that it would be “unfair” for the IRS to have access to its spreadsheets. The court stated that “tax collection is not a game,” that there is a public interest in revenue collection, and that if a “blueprint” could be found to improper deductions, the IRS was entitled to see it. The court pointed out that the goal is discovering the truth.

The court also seemed concerned with the practical problem the IRS has in discovering the under-reporting of corporate taxes, which it stated was “endemic.” Textron’s consolidated return was over 4,000 pages. The IRS requested the work papers only after finding specified abusive transactions. Discovery tools granted to the IRS were deemed to be essential to the collection of revenues.

The court held that the work product privilege was aimed at protecting work done for litigation, and not for preparing financial statements and seeking auditor approval. Further, “IRS access serves the legitimate and important function of detecting and disallowing abusive tax shelters.”

The two dissenters asserted that the majority abandoned the First Circuit’s “because of” test set forth in its prior decision in *Maine*, which asks whether “in light of the nature of the document and the factual situation in the particular case, the document can be fairly said to have been prepared or obtained because of the prospect of litigation.” The “because of” test stemmed from the Second Circuit’s decision in *United States v. Adlman*.²⁰ They argued that the majority adopted a new standard, “prepared for use in possible litigation,” a test the dissenters opined is even narrower (i.e., less likely that documents would be privileged) than the widely rejected “primary motivating purpose” test used in the Fifth Circuit and specifically rejected by the First Circuit. They further argued

that the majority ignored a "tome" of circuit court precedents regarding the work-product doctrine and, consequently, they contravened much of the principles regarding the work-product doctrine.

The dissenters would follow neither the majority's "prepared for use in possible litigation" test, which they argued was a new narrower test, nor the "primary motivating purpose" test of the Fifth Circuit. They believed that the "because of" test in *Maine*, which they claimed was ignored by the majority, was the correct test and one more in line with five other circuit courts of appeals. Furthermore, they claimed that the majority brushed aside the clear text of Rule 26(b)(3), which refers to documents prepared to aid in the conduct of litigation. They also asserted that the majority ignored the findings of the District Court, which were not clearly erroneous.

The minority also disagreed about the majority's reliance on *Maine*. In that case, the state of Maine had sought documents from the Department of the Interior regarding its decision to classify salmon as a protected species. The District Court found some of the documents to be unprotected since the Department had not shown that litigation was the "primary motivating factor" underlying their preparation. On the *Maine* appeal, the dissenters pointed out that "we....repudiated this test and adopted the broader 'because of' test adopted by the Second Circuit."²¹ The "because of" test the dissenters argued is appropriate where there is a dual purpose for preparation of the documents: both business purpose and anticipation of litigation. They also asserted that documents should be protected if they are prepared simply *to aid* in litigation – as stated in Rule 26(b)(3) – much less primarily or exclusively to aid in litigation. Preparing a document "in anticipation of litigation," the dissenters believed, was sufficient for it to be protected. They felt that the proper test had been spelled out in

Adlman, which the dissenters opined was adopted by the First Circuit in *Maine*, and that "[t]he majority's opinion is simply stunning in its failure to even acknowledge this language and its suggestion that it is respecting rather than overruling *Maine*."²²

The dissenters concluded that while the majority's decision might please the IRS and tax scholars that view discovery as a means of combating fraud, the decision threw the doctrine of work product doctrine into disarray, an issue on which circuit courts of appeal are split. They believed that the issue was "ripe" for hearing by the Supreme Court to clarify this important issue.²³

Textron filed a petition for *certiorari* with the U.S. Supreme Court seeking review of the First Circuit ruling. The importance of the *Textron* case, at least to litigators, is evidenced by the fact that at least eleven interested parties submitted *amicus curiae* briefs to the Supreme Court supporting the appeal.²⁴

On May 24, 2010, the Supreme Court declined to hear Textron's appeal, thus letting stand the First Circuit's decision allowing the IRS to demand tax work papers from corporations.²⁵

III. CONCLUSION

Since finding the truth is the primary purpose behind all discovery tools, privilege claims must be carefully scrutinized. Concerning tax accrual work papers, the standards promulgated by the courts to determine whether there is protection from discovery requests are the "but for" and "primary use" tests. Textron failed both.

In recent years, there has been considerable pressure for both government and corporations to be more transparent. This is the goal of the IRS when tax collections are down and the government faces large budget deficits. In this regard, the IRS has pressed for disclosure by foreign financial institutions of bank accounts owned by U.S. taxpayers. To avoid more serious penalties, including possible criminal charges, at least 18,000 taxpayers have voluntarily disclosed foreign bank accounts. Some foreign banks have reached settlements with the IRS to disclose the names of taxpayers holding accounts in their institutions.

With the approval of both the First and Fifth Circuits behind it, the IRS seemingly could go after tax accrual work papers regularly if it wanted to do so. The decision appears to have created considerable confusion about the parameters of IRS discovery. Also, the decision could have some impact on non-tax litigation. Attorneys may be reluctant to put in writing their candid risk assessment as to the chances of winning or losing since they may not be confident that what they have written will be protected from discovery.²⁶

In a subsequent speech to the American Bar Association, Commissioner Shulman stated the IRS is clarifying and strengthening its policy of restraint.²⁷ He made three points in this regard: (1) Disclosing issues on Schedule UTP would not affect the IRS policy of restraint; (2) Drafts of issue descriptions and information regarding ranking of issues are protected; and (3) the IRS will not seek documents that would otherwise be privileged even though shown to the taxpayer's auditor.

¹ IR-2010-13, Announcement 2010-9. The Announcement was part of Prepared Remarks of IRS Commissioner Doug Shulman to the New York State Bar Association Taxation Section Annual Meeting in New York City on January 26, 2010.

² IR-2010-098, Announcements 2010-75 and 76. The Announcements were part of Prepared Remarks of IRS Commissioner Doug Shulman to the American Bar Association in Toronto on September 24, 2010.

³ *Id.*

⁴ 577 F.3d 21 (1st Cir. 2009); 2009 U.S. App. LEXIS 18103.

⁵ The law professor is Professor Claudine v. Pease-Weingenter, Phoenix School of Law.

⁶ See 15 U.S.C. §§ 781, 78m (2006); 17 C.F.R. § 210 *et seq.* (2009).

⁷ See *United States v. Arthur Young & Co.*, 466 U.S. 805, 812-13 (1983).

⁸ See Reg. § 1.6011-4(b)(2) (2009).

⁹ SILOs allow tax exempt or tax indifferent organizations (e.g., a city owned transit authority) to transfer depreciation and interest deductions, which do not benefit them, to taxpayers who can use the deductions to shelter other income. If the only motive for the transaction is tax avoidance, the IRS could disallow the benefits on the theory that there is no business purpose.

¹⁰ Pursuant to IRC §7602 (2006).

¹¹ IRS Announcement 2002-63, 2002-27 IRB 72 (July 8, 2002).

¹² See IRC §7604(a) (2006).

¹³ *United States v. Textron Inc.*, 507 F. Supp. 2d 138, 150, 155 (D.R.I. 2007).

¹⁴ 329 U.S. 495 (1947).

¹⁵ 298 F. 3d 60 (1st Cir, 2002).

LEGAL INSIGHTS ON MANDATORY FLU VACCINATIONS

by

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INTRODUCTION

The 2009-2010 swine flu pandemic was an historic health event of global proportion. The first influenza pandemic in over 40 years affected communities in virtually every country throughout the world. Although the recent pandemic has abated, questions regarding how it was handled and the consequences from the response remain unanswered. This article first enunciates, background information about the H1N1 flu, its global reach and subsequent responses by government and public health agencies are discussed. Next the recent controversy over mandatory H1N1 flu vaccination policies for employees, particularly those in health care fields, is examined. The debate in New York State over its Department of Health flu vaccination mandate and potential legal challenges to mandatory flu vaccination policies follows. As a conclusion, managerial suggestions to avoid employee litigation are presented.

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¹⁶ Pease-Weingenter, *The Application of the Attorney-Client Privilege to Tax Accrual Workpapers: The Real Legacy of United States v. Textron*, 8 Houston Bus. & Tax L.J. 337, 346 (2008).

¹⁷ 462 U.S. 19, 25 (1983).

¹⁸ Coastal States Gas Corp. v. Dep't of Energy, 617 F. 2d 854, 858 (D.C. Cir. 1980). (other citations omitted by author).

¹⁹ 682 F. 2d 530, 543 (5th Cir. 1982), *cert. denied*, 66 U.S. 944 (1984).

²⁰ 134 F.2d 1194, 1202 (2d Cir. 1998).

²¹ *Id.*

²² *Supra* 4 at 38.

²³ *Supra* 4 at 65.

²⁴ Roger Russell, *Supremes Mull Textron Petition*, Accounting Today, Vol. 24, No. 4, April 19-May 9, 2010, at 10.

²⁵ *Supreme Court Nixes Textron Appeal in IRS Case*, WebCPA (by WebCPA staff), May 24, 2010, <http://www.webcpa.com>; 2010 LEXIS U.S. App. LEXIS 13226.

²⁶ *Id.*

²⁷ *Supra* 2.